A proposal for a new international debt framework (IDF) for the prevention and resolution of debt crisis in middle-income countries

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Abbreviations

BIS	Bank for International Settlement
CACs	Collective Action Clauses
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
IDF	International Debt Framework
IDFC	International Debt Framework Commission
IIF	Institute of International Finance
IMF	International Monetary Fund
NPV	Net Present Value
OTC	Over The Counter
SDRM	Sovereign Debt Restructuring Mechanism

Summary

The present lack of a comprehensive framework for sovereign debt restructuring not only generates significant costs but also endangers the stability of the international financial system. In addition, collective action problems involved in the restructuring of sovereign bonds place an obstacle to an orderly and rapid restructuring. The case of Argentina presents a good example for difficulties a sovereign – but also private-sector stakeholders – may face in the absence of an orderly debt-restructuring mechanism.

This paper outlines a possible approach for a new International Debt Framework (IDF) that represents a middle ground between a legally binding insolvency procedure and a voluntary code of conduct. A comprehensive restructuring mechanism could be successful only if it were certain that it would meet with intergovernmental support and leadership on the part of both developed and developing countries. Since the Group of 20 (G20) meetings of finance ministers from developed and developing countries have proved to be a successful forum for analyzing and dealing with instabilities of the international financial system, we propose the G20 as the forum to initiate the establishment of the IDF. With a view to ensuring predictability for international creditors, our proposal also includes a general set of principles similar to those contained in the recent proposal for a code of conduct made by leading sovereign issuers of international bonds and leading private creditors.

The IDF should have two functions: crisis prevention and crisis resolution. Permanent debtor-creditor dialogues and transparency and information on emerging-market debt markets are necessary to prevent crises. Under the new IDF this would be ensured through the creation of a permanent IDF secretariat. All stakeholders would be entitled to nominate members for the secretariat.

What is needed to resolve the situation of a financially distressed sovereign is facilitation of an orderly debt-restructuring mechanism. An IDF Commission (IDFC) would assume this function; it would be made up of representatives from the sovereign debtor, private creditors, multilateral lenders, and sovereign creditors. In contrast to the International Monetary Fund's proposal for Sovereign Debt Restructuring Mechanism (SDRM), the underlying framework for the IDF would not be statutory. According to the proposal, the IDF Commission would aim for a coherent and comprehensive debt restructuring, propose the amount of financial support required, and outline the economic adjustment path that could guarantee long-term debt sustainability.

1 Introduction

A series of financial crises in emerging markets since 1994 and the role played by bonds in gradually expanding the credit base of middle-income countries have posed major challenges in resolving sovereign debt problems. These developments have opened a debate in the international community on the need for a new framework that recognizes that private and public creditors are equally involved in a debt restructuring process.

1.1 Shortcomings in the current debt-restructuring system

In circumstances in which a country's debt burden has become unsustainable, its debt has to be restructured. The problem with the existing ad hoc machinery designed to restructure debt on a case by case basis is that the processes involved are disorderly, delayed, and inefficient, generate undue costs for both debtors and creditors and at the same time constitute a source of contagion for entire emerging markets. The costs involved include for example falling real output and increasing real interest rates and/or inflation rates, etc.

While restructuring processes are often delayed due to great costs for sovereign debtors, the delay itself triggers enormous costs for both creditors and debtors. Other reasons for a delayed debt restructuring procedure are uncertainties about the restructuring process itself. An orderly debt-restructuring mechanism that is both predictable and based on a general set of principles endorsed by creditors and debtors alike would lead to an initiation of a restructuring process at an earlier stage.

Since the creditor groups holding sovereign bonds are large and heterogeneous, there are serious coordination problems when it comes to restructuring. These coordination problems associated with sovereign bond restructurings are greater than those involved in restructuring other debt instruments, because creditor groups holding other debt instruments are not that heterogeneous. International bank loans, for example, are often held by banking syndicates consisting of a small number of large international banks. Collective action problems have, to date, made the cost of restructuring excessively high for debtors and creditors alike, and they are an important obstacle to the rapid recovery of a sovereign debtor. Three collective action problems play an important role in coordinating private creditors.[1]

- **The holdout problem**: A restructuring procedure that is acceptable to a majority of creditors can be blocked by a creditor minority (holdouts). As a result creditors have an incentive not to participate in the restructuring process and will wait until the debtor is in a better financial situation in order to enforce their claims in full after conclusion of the restructuring process.

- **The rush to the exit problem**: If creditors fear the risk of a financial crisis, they are likely to seek to sell their bonds immediately. From the perspective of an individual

1 For an overview of collective action problems, see Berensmann (2003); Roubini (2002).

creditor this would be a rational decision, since he could in this way secure a better price for his claims than other bondholders who deal with a financially distressed sovereign debtor at a later stage.

- **The rush to the courthouse problem**: Individual bondholders have an incentive to take recourse to litigation to enforce their claims.

1.2 Procedures of the current system of debt-restructuring

New operational instruments need to be developed to solve international debt problems for middle-income countries because existing instruments such as collective action clauses (CACs) are not sufficient. CACs are not a comprehensive approach for the restructuring of sovereign foreign debt since they do not require adequate aggregation of different debt instruments (such as loans and bond issues).[2]

There are two further approaches currently under discussion: a voluntary approach – a code of conduct[3] – and an international insolvency procedure. A code of conduct would only be effective if it were binding in nature. Although a code of conduct could contribute to resolving the collective action problems mentioned above, it could not fully resolve them. A code of conduct is not an instrument that could prevent the rush to the exit problem, it would offer no protection against litigation by creditors, and it would provide no additional safeguards against holdout behavior. For several years various proposals for a code of conduct have been discussed in the international community. While they are in principle accepted by most actors in international financial markets, they have not yet been implemented.

Several proposals for an insolvency procedure exist.[4] Yet, the most recent and well known one is the Sovereign Debt Restructuring Mechanism (SDRM) proposed by the International Monetary Fund (IMF), which would provide a legal framework for dealing with overindebted countries. It would not only make it possible for financially distressed sovereigns to engage in an orderly debt restructuring process with its creditors, this approach could furthermore resolve the three collective action problems outlined above. However, the SDRM was put on hold in April 2003 due to resistance by financial market investors and governments of developing countries. Most governments of emerging markets fear losing access to international capital markets once such a procedure had been initiated (Filho 2003; Roubini / Setser 2003). One additional concern of the critics of the SDRM is that, as a major creditor, the IMF would not be a neutral party in the negotiations that a debtor country enters into with other creditors (Herman 2003, 217). Private-sector credi-

2 For an overview of instruments available to restructure sovereign bonds as well as of the advantages and disadvantages of CACs see Berensmann (2003).

3 The most important proposals on the formulation of a code of conduct are the Trichet proposal, a proposal by the private sector, and a private-sector proposal prepared in coordination with leading sovereign issuers of international bonds. See Banque de France (2003); EMCA et al. (2003) and IIF (2004).

4 A history of ideas regarding international insolvency procedures can be found in Rogoff / Zettelmeyer (2002).

tors, in particular banks, generally have rejected the SDRM approach because the procedure could serve to increase debtor moral hazard. In addition, not only the amendment to the IMF Articles of Agreement that would have been necessary to implement the SDRM, the required translation of this new international insolvency procedure into national legislation has also been a matter of some contention (EMCA et al. 2002).

Even though intergovernmental consideration for an SDRM has come to a halt, it is nevertheless important to acknowledge that the general notion of an international insolvency procedure is the only proposal so far that could be used to aggregate debt classes and to group debts within these classes.

Against this background the paper will address two major challenges to the international financial system: First, lack of adequate information on and analysis of emerging country debt markets and a forum for dialogue on these issues which engages all stakeholders in the international financial system. Second, the need in the international financial system for a comprehensive approach to restructuring sovereign debt.

The following sections will outline the proposal for a new International Debt Framework (IDF) that could offer a solution lying somewhere between a legally binding SDRM and a voluntary code of conduct. It could be designed in such a way that it would address coordination problems between debtors and creditors and serve as a substitute for existing ad hoc mechanisms such as the Paris Club, which deals only with public debt, and the London Club, which deals only with private debt.

2 The present debt situation in emerging markets

Debt sustainability is currently at risk in four emerging market countries that are members of the intergovernmental Group of 20 (G20). The World Bank classifies Argentina, Brazil, Indonesia, and Turkey as severely indebted countries.[5] A country's external debt can be considered unsustainable if the country is not able to meet all of its current and future debt-service payments without having to restructure its debt, and without endangering its prospects of economic growth (IMF / IDA 2001).

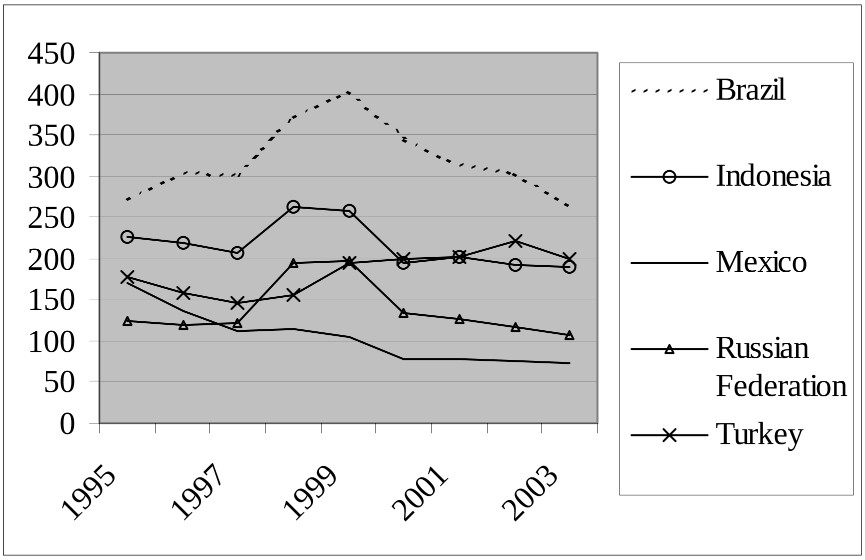
There are problems involved in identifying the "correct" indicators for assessing a given country's debt sustainability. The approach is to define a proper quotient for debt stocks or, alternatively, debt-service payments (numerator) expressed in proportion to variables that reflect a country's potential repayment capacity (denominator); the latter may include, for example, gross domestic product (GDP), exports, or government revenues.

5 See World Bank (2005). In classifying countries as severely indebted, the World Bank uses two criteria: the ratio of present value of debt service to gross national income (GNI) and the ratio of the present value of total debt service to exports. The first criterion needs to be higher than 80 % and the second higher than 220 %. However, these data are not available. Published debt indicators include total external debt to exports of goods and services or total external debt to gross national income, but no data are available on present value of debt service to gross national income (GNI) and present value of total debt service to exports.

Even assuming that the "correct" indicators are chosen, it is difficult to set the "correct" threshold values for a country's debt sustainability. In addition, it is difficult to identify one uniform threshold for all countries. Under the HIPC Initiative, for example, a country's debt is regarded as unsustainable if its debt (net present value[6]) to export ratio exceeds 150 % or, alternatively, its debt stock (net present value) exceeds 250 % of government revenues.

In 2003 three emerging markets had a debt to export ratio in excess of 150 %: Brazil, Indonesia, and Turkey (Figure 1). Since 1996 this ratio for Brazil has even been twice as high as the threshold defined under the HIPC Initiative. It must be taken into account, however, that we have used present values of debt stocks because net present values are not available. Russia's debt to export ratio has declined substantially since 1999.

Figure 1: Debt stock in terms of exports (in percent)

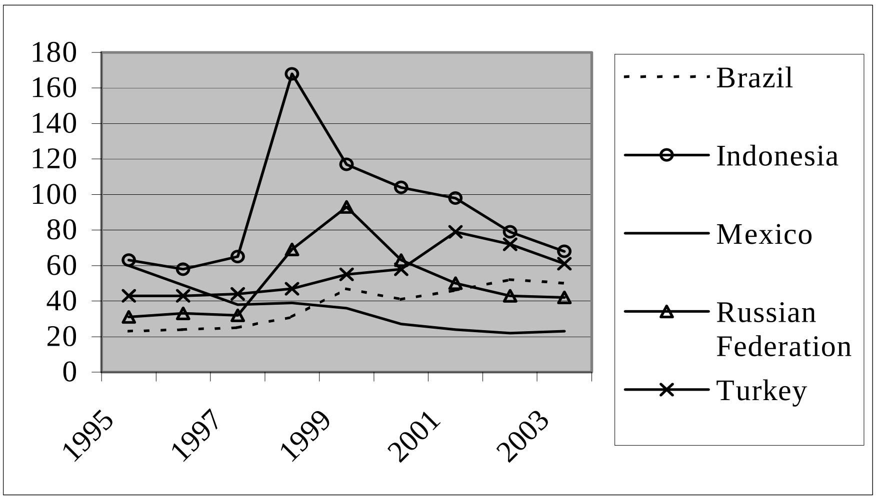


Source: World Bank (2005), Global Development Finance

Debt sustainability can also be measured by using debt stocks as a proportion of gross national income (GNI). As difficult as it may be to define a threshold for the level of unsustainable debt, a debt to GNI ratio in excess of 50 % may be said to pose a danger to debt sustainability. In Brazil, Indonesia, and Turkey this ratio was above 50 % in 2003. Moreover, in Brazil, the ratio has been moving upwards (Figure 2).

6 It is possible to adopt either the present value or the net present value (NPV) of debt stocks. Since a certain share of external credit is provided on concessional terms, IMF and Word Bank have used the net present, which takes into account the degree of loan concessionality involved. The market interest rate is used to discount the sum of all future debt-service obligations (interest and redemption) down to their present value. In case the interest rate on a loan is below the commercial level, the net present value of a debt will be lower than its present value. The differential between these two variables is, finally, the grant component.

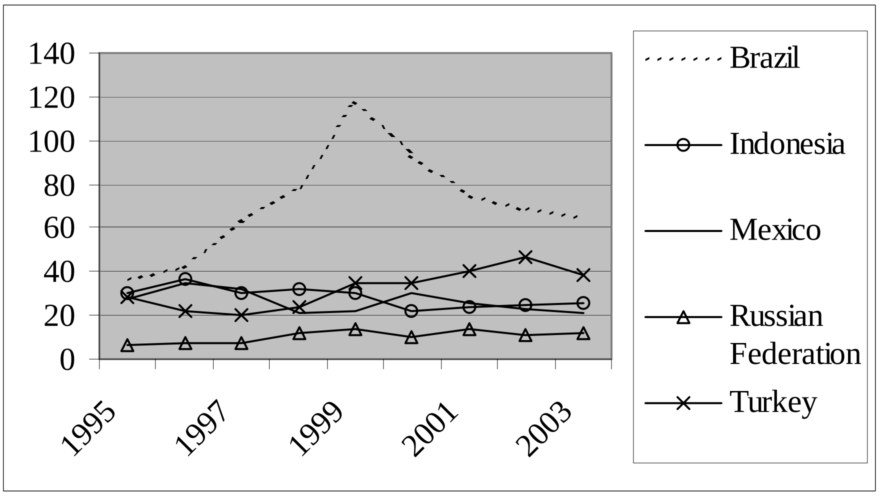
Figure 2: Debt stock in terms of GNI (gross national income) (in percent)



Source: World Bank (2005)

A debt service to export ratio above 30 % indicates an unsustainable level of debt (Figure 3). In Brazil this ratio fluctuated between 37 % and 118 % between 1995 and 2003. In Turkey the debt service to export ratio has been greater than 30 % since 1999.

Figure 3: Debt service in terms of exports (in percent)



Source: World Bank (2005)

3 Argentina's default and its negotiations with private bondholders

The governments of many developing countries have objected to an international debt restructuring mechanism, fearing that it might delay restoration of access to capital markets and adversely affect other emerging market countries. The largest sovereign debt default in contemporary history, declared by Argentina in December 2001, provides a new template of what difficulties a sovereign debtor – but also private-sector stakeholders – face in the absence of an orderly debt restructuring mechanism. Regardless of how Argentina's debt is finally settled, the Argentine crisis has brought about an unprecedented long-term social and economic loss for its citizens, and there is no denying the huge loss for public and private investors (Hornbeck 2004). As a result of the financial collapse in December 2001, GDP declined at a record 16.3 % annual rate in the first quarter of 2002, unemployment levels jumped to 21.5 % of the labor force, real monthly wages declined by 18 % over the course of 2002 and 53 % of Argentines had to bear living standards below the official poverty line (Cibils et al. 2002).

Private investors were outraged not only by the fact that they were expected to take the largest debt write-down of all creditors, they were moreover distressed by Argentina's refusal to enter into negotiations with its private bondholders for over 20 months following the crisis. The fact immediate readmission to global capital markets is not necessarily a high priority for a defaulting government is explained best by James Carville: "*Governments, keen to borrow on favorable terms, will go to great lengths to maintain their good standing in the capital markets. After a default, however, a government no longer has any standing to worry about. It has nothing left to loose* (The Economist 2004)." As a matter of fact, the Argentine economy regained real economic growth amounting to 8.8 % in 2003 and 7.0 % in 2004 despite being cut off de facto from world capital markets (IMF 2004).

In September 2003 Argentina presented for the first time a unilateral offer to its bondholders that translated into a debt write-down of 75 % of eligible principal payments and 100 % of past-due interest payments. This proposal was not only immediately rejected by the groups organized to represent Argentine bondholders,[7] the degree of desired relief was on the order of over 90 % on a net present value basis, and it had no parallel in Argentina's financial history (Porzeczanski 2004, 27). After earnest negotiations with bondholder groups in the first half of 2004, Argentina continued to take a tough stance with its creditors by insisting on a level of debt relief that, according to its own estimates, would ensure that its debt service would not exceed a primary fiscal effort[8] of 3 % of GDP. This translates into an overall debt write-off amounting to 75 % of the country's outstanding debt on a present value basis. Moreover, Argentina announced in August 2004 the suspension of its IMF agreement, thereby giving up temporarily access to further lending and casting off IMF conditionality (Hornbeck 2004, 11). This was a political move that enabled the Argentine government to emancipate itself from IMF oversight in the impending debt-workout negotiations with private investors.

7 For details, see Argentina Bondholders Committee (2003).

8 Fiscal effort is measured on the basis of the so-called primary fiscal surplus, namely the excess of current revenues over current and investment outlays before consideration of interest payments. According to Porzeczanski (2004, 27) the Argentine pledge for a fiscal effort of 3 % falls short of the offers made by countries in similar straits – like Brazil, Ecuador, and Turkey – which were on the order of 4–6 %.

Based on its debt sustainability calculations the Argentine authorities formally launched a debt swap offer to the country's private bondholders in early 2005 and lobbied financial markets in order to achieve an acceptably high participation rate of private investors. The country surprised many by achieving a 76 % acceptance rate for its debt restructuring in February 2005. The haircut – about 66 cents on the dollar – is one of the highest ever for a sovereign debt swap.

However, while the high costs of litigation and protection of state assets from embargoes have so far all worked to Argentina's advantage, the situation could change once the government starts to service the debt after completing restructuring with the majority of its creditors. A well-crafted lawsuit could stop payments to creditors who accept the government's offer, since financial flows can not be embargoed. A committee of bondholders that is in disagreement with the offer by the sovereign could pool its holdings and sue the Argentine government in court for full recovery, thus complicating the restructuring process.[9]

From the experience made in course of the Argentine restructuring process we can conclude that once insolvency occurs and debt becomes far too large to manage, there is little incentive for countries to work with the existing, unenforceable system in finding a quick and consensual solution. Argentina's default has thus far been very costly, not only for its creditors but in particular for its citizens, who are now forced to bear long-term social and economic hardships. Moreover, despite the high participation in the Argentine debt swap the debt restructuring process may be endangered by possible litigation, due to collective action problems.

Therefore, this recent experience should reinvigorate interest in a more systematic and internationally recognized debt restructuring mechanism, as outlined in the next section.

4 The proposal for a new International Debt Framework (IDF)

The main objective of an orderly debt-restructuring mechanism as soon as a sovereign default occurs is to create an environment in which the debtor government can negotiate in good faith with all of its foreign creditors, such as multilateral and bilateral donors, commercial banks, bondholders, and if necessary its domestic creditors. Furthermore, an entity that would provide for continuous dialogue on crisis prevention between the international financial community and emerging markets' governments, and policymakers could be another beneficial feature for the current system.

This section will introduce a proposal for a new operational instrument called the International Debt Framework (IDF). It would have two important functions:

9 Moreover, investors, including futures funds, have been attracted to defaulted emerging market debt in recent years, buying paper (bank loans, supplier credits, or bonds) with the intention of suing for full recovery. Most of these investors have been successful in their litigation or out of-court settlements, achieving on average 20 times the value of their initial investment (see Singh 2003, 8 ff.).

1. *Provision of transparency and information on emerging market debt markets through regular dialogues between debtors and creditors (crisis prevention).*

2. *Facilitation of an orderly debt restructuring mechanism if requested by a sovereign defaulting debtor (crisis resolution).*

The proposal for an IDF recognizes that such a facility could only be successful if it was possible to secure intergovernmental support and leadership by developed and developing countries. Given the importance of such a mechanism for middle-income countries, we feel that the most appropriate forum to initiate the establishment of the IDF would be the Group of 20. The G20 meetings of finance ministers from developed and developing countries have been a relatively successful forum to discuss issues such as how to deal with financial instability and better manage sudden capital inflows and outflows (Sagasti / Bezanson / Prada 2004, 78), and from the perspective of the most important emerging market countries, the G20 is far more representative than institutions dominated by the G7.[10]

The underlying framework of the IDF would not be statutory, unlike the SDRM approach of the IMF, and its principles would be established by best practices. In the case of a sovereign default it could allow for a multilateral convention by "all relevant stakeholders to restructure unsustainable debts in a timely and efficient manner,"[11] as called for by the Monterrey Consensus of the UN Conference on Financing for Development.

4.1 General principles / code of conduct

One of the tasks of the non-statutory framework of the IDF proposal for the management of sovereign debt would be to ensure predictability for international creditors. This could be achieved by adopting a general set of principles that would have to be formally endorsed by all G20 member countries and find the support of a majority of international creditors. In this regard joint initiative for such a code of conduct recently launched by leading sovereign issuers of international bonds (Brazil, Korea, Mexico, and Turkey) as well as by leading private creditors could serve this purpose:

The principles, as listed in Box 1, have already gained support by leading industrialized countries and developing country members of the G20, including China, India, Indonesia, Russia, and South Africa.[12] However, since a decision by the G20 on a code of conduct seems only be a matter of time, the effectiveness of these general principles for emerging market finance will depend on the development of a new international mechanism that promotes compliance by all relevant actors. This could be achieved through the creation of an International Debt Framework (IDF) as outlined in the following sub-sections.

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10 Such institutions include the Financial Stability Forum, but also the Bretton Woods Institutions (BWIs). For a critique of the governance structures of the BWIs, see Caliari / Schroeder (2002) and Buira (2003).

11 See Paragraph 60 of the Monterrey Consensus, adopted by the Heads of States and other Government Officials in Monterrey, Mexico, 2002.

12 Press Release, Institute of International Finance (IIF), November 22, 2004.

Box 1: Principles for stable capital flows and debt restructuring in emerging markets

1. Transparency and timely flow of information

- **General disclosure practice**: Debtors should guarantee by means of disclosure of relevant information that creditors are able to conduct thorough assessments of a debtor's economic and financial situation.
- **Specific disclosure practice**: The debtor should disclose all information about the structure and amount of his debts to all creditors.

2. Debtor-creditor dialogue and cooperation to avoid restructuring

- **Regular dialogue**: Debtors and creditors should participate in a regular dialogue.
- **Best** practices **for investor relations**: An investor relations office should be established to improve communication techniques.
- **Policy** action **and feedback**: Debtor countries should implement economic and financial policies designed to guarantee macroeconomic stability and promote sustainable economic growth.
- Consultations: Debtors and creditors should assess alternative market-based instruments for re structuring debt.
- Creditor support of debtor reform efforts: Creditors should consider voluntary, temporary continuance of trade and inter-bank advances. In addition, consideration should be given to a roll over of short-term maturities on public- and private-sector debt.

3. Good faith actions

- Voluntary**, good faith process**: Debtors and creditors should whatever efforts needed to ensure timely good faith negotiations.
- Sanctity **of contracts**: Contracts should be upheld and altered only if both parties are agreed.
- Vehicles **for restructuring**: Creditor committees should be established flexibly and on a case by case basis.
- **Creditor committee policies and practices**: In case a creditor committee is established, it should adhere to rules and practices, for example, coordination of various debt instruments or protection of non-public information etc.
- **Debtor and creditor actions during restructuring**: As far as possible, debtors should resume debt service payments. Debtors and creditors would ensure that trade lines are fully serviced and, maintained during a restructuring process.

4. Fair treatment

- Avoiding **unfair discrimination among affected creditors**: Debtors should guarantee equal treatment of all creditors.
- **Fairness of voting**: The result of a vote among creditors on a restructuring effort should not be affected by bonds, loans, and other financial instruments owned or controlled by the sovereign**.**

Source: For a more detailed description of this proposal see IIF (2004).

4.2 Establishment of an IDF secretariat and its functions

A first step towards the establishment of an IDF instrument would be the creation of an IDF secretariat (see Appendix), which would include the first and second principles of the above-mentioned code of conduct (Box 1) and take on the following functions:

- **Preparation and analysis of information**: The main function of this technical body would be to prepare and analyze information on emerging country debt markets[13] as well as of risk assessments that would be presented in periodic status reports and made available to all interested middle-income countries.

- **Decision on debt sustainability**: The IDF secretariat should assume the task of developing criteria for long-term debt sustainability. Members would need to define indicators and thresholds for debt sustainability. Experts from multilateral institutions, the private sector, and academia could support the IDF secretariat in this undertaking.

- **Information exchange channel**: By facilitating regular dialogues between debtors, creditors, and financial market experts, the IDF secretariat could provide an important channel of information exchange geared to lowering market uncertainties.

- **Forum for middle-income countries**: The IDF could also serve as a forum for G20 governments and other middle-income countries to address economic policy decisions and debt problems, in particular if creditor concerns are on the rise and economic difficulties appear to be accumulating. The IDF secretariat, which would serve as an instrument of crisis prevention, should stay in close contact with finance ministries of G20 member states, interested middle-income countries, and other multilateral organizations such as the Bretton Woods Institutions, United Nations Conference on Trade and Development (UNCTAD), and the Financial Stability Forum and private-sector entities that gather relevant information on financial markets.

- **Confidentiality of sensitive information**: One important feature of the IDF secretariat would be to guarantee the confidentiality of sensitive information regarding the economic and financial situation of middle-income countries that could otherwise lead to hasty conclusions and policy decisions by financial market investors.[14]

If the IDF secretariat proved successful in gaining acceptance and recognition in the international community and serve as a successful convener for regular multi-stakeholder meetings on debt and development, its contribution to a future orderly debt-restructuring mechanism would be of crucial importance. The IDF secretariat could contribute to preventing a rush to the exit because creditors would have better information on debtors, and this would improve predictability in international financial markets regarding the repayment capacity of sovereign debtors.

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13 This should also include price reporting by dealers and brokers on OTC securities.

14 In the case of incidence of sovereign default and negotiations on debt restructuring for a G20 country, disclosure of all relevant information on the debtor's financial and economic situation would have to be ensured.

Members of the IDF secretariat

A G20 initiative on the establishment of an IDF secretariat would require a selection mechanism to nominate a small group of eminent experts on debt and economic development. To ensure adequate representation of debtors and creditors, all stakeholders would be eligible to nominate persons for the IDF secretariat. G20 countries as well as interested middle-income countries, debtors and creditors alike, need to be represented. Two or three persons could be chosen by the G20. Similarly, private creditor associations and the international financial institutions, such as the IMF or the Bank for International Settlement (BIS), would be able to nominate persons to be members of the IDF Secretariat.

Creditors and debtors would have to agree on a concrete selection mechanism and the concrete number of persons involved. To ensure that this new body would not be just another agency in the international multilateral system, the new body should not be made up only of public officials.

Costs

Debtor and creditor countries as well as private creditors and international financial institutions would have to carry the costs because all parties would benefit from the IDF secretariat's work.

4.3 An IDF debt restructuring mechanism

The debt restructuring process would be formally established by the creation of an IDF Commission (IDFC) which would have the characteristics of an independent ad hoc body (see Appendix). A code of conduct would be recognized in the restructuring mechanism, in particular the third principle, "Good Faith Actions," and the fourth principle, "Fair treatment," which are part of the above mentioned code of conduct (Box 1).

Activation of a restructuring process

The debtor would initiate the restructuring mechanism. Neither creditors nor any international financial institution would be entitled to activate a restructuring process under the IDFC. A restructuring process should be initiated in the case that a county's debt has become unsustainable. Exact criteria for unsustainable debt would have to be defined.

Members of the IDFC

The IDFC would be made up of representatives of the debtor, private creditors, multilateral lenders, and sovereign creditors. Members of the IDF secretariat would have to agree on an appointment process for the restructuring mechanism and assist in the selection of mediators who would serve as external advisors in the negotiation process.

Tasks of the IDFC

The IDFC's overarching goal in the sovereign debt restructuring process would be to aim for a coherent and adequate solution that defines the amount of necessary financial support and an economic adjustment path that could ensure long-term debt sustainability. If a debt write-off should prove necessary, the IDFC would also define the level of debt relief.

The IDFC would be responsible for the valuation of claims. The value of external claims should be fixed on the date of activation. Furthermore, the IDFC would have the task of deciding, by consent of the majority of creditors, on any extension of a sovereign debtor's stay.

The experience of the IDF secretariat in the preparation and analysis of information on emerging country debt markets could be an important contribution to providing an overall outlook on the international and domestic economy, the amount that official and private inflows might account for after restructuring, and the potential for economic growth. The IDF secretariat would assist the ad hoc body by establishing early communication with creditors, facilitating the formation of creditor committees and classes.

Features of the IDFC

Types of debt be covered

Another important issue is the question of what claims would be restructured under the IDFC. The principle of equal treatment of all creditors would indicate a need to include all types of external debt. For this reason all public – multilateral and bilateral – as well as private creditors should take part in the restructuring negotiations under the IDFC.

Bilateral public-sector creditors should also be included in a restructuring process as a means of guaranteeing equal treatment for all creditors. Moreover, the bilateral public-sector creditors constitute a very important group of creditors outside the private sector. If the public bilateral creditors were not included, the only claims restructured under the IDFC would be those held by private and public multilateral creditors.

However, it can not be ignored that provision of new financing in times of crisis is an important element for the quick recovery of a financially distressed sovereign debtor. Therefore, the debt restructuring mechanism should create an incentive for creditors to provide additional credits that would be honored in the debt restructuring process; this would involve special treatment of sovereign debtor liabilities to creditors that make new financing available. Moreover, trade credits, in particular for exports, are important to the functioning of the economy, and without such credits a country could find itself in danger of being cut off from the world markets. In some cases it may therefore be reasonable to exclude trade credits from the restructuring process and to require the sovereign debtor to service such trade credits that are vital for the economy.

In general, multilateral creditors such as the IMF or the World Bank should not enjoy privileged status. While it could be argued that inclusion of multilateral institutions could, because of the limited financial resources at their disposal, endanger their financial viability it should be borne in mind that their policy prescriptions and conditionalities in fact have not prevented financial crises.[15]

Given the special role that the IMF plays in providing new financing in times of crisis as a lender of last resort, its preferred creditor status should be recognized only if IMF conditionalities and the Fund's proposed economic policy framework will be subject to the restructuring negotiations in the framework of the IDFC.

Treatment of domestic debt in the restructuring process could follow different approaches. Even though the main objective is to reach sustainable levels of external debt, the ability of debtor countries to repay their debt is affected by their domestic fiscal situation. Restructuring of domestic debt should therefore be coordinated with restructuring of external debt. It should be decided on a case by case basis whether the claims of resident investors should be the subject of the majority restructuring of all outstanding debt, or alternatively, whether domestic debt should be excluded from the IDF framework and a government should rely instead on existing domestic legal frameworks to facilitate any restructuring of these claims.

Stay on enforcement

In the case that a financially distressed G20 member country or other middle-income countries interested in making use of the proposed debt restructuring mechanism finds that it can no longer service its outstanding debt, it needs a stay on creditor enforcement in order to suspend temporarily its debt servicing to all its creditors. Moreover, since a sovereign debtor that faces the risk of default is confronted with a severe coordination problem and has to find solutions to acquire new financing, a stay would provide the sovereign debtor a necessary safeguard in times of crises.

One further advantage bound up with a stay is that it would make immediate debt restructuring possible, and thus creditors would have an incentive to participate in negotiations. In addition, a stay would contribute to equal treatment of all creditors because no creditor would receive payments during a stay. For this reason, a debtor would be unable to misuse a stay by making payments to preferred creditors.

One drawback of a stay, however, is that it is important to keep the economies of debtor countries going. Payment on trade credits that are vital for the economy, for example, have to be maintained to keep up trade with foreign countries (Berensmann 2003).

15 Argentina's default is particularly revealing as the IMF was deeply involved with Argentina for many years prior to the 2001 crisis and Argentina's policies and performance were subject to intense IMF scrutiny and conditionality. For further details, see Rambarran (2004).

Negative effects of stays, such as sudden capital flight or contagion effects on other countries, are often overstated, because these consequences are more likely to be determined by general economic policy and performance rather than by stays.

Contingent on approval by a qualified majority of G20 member states, the IDFC framework would give a sovereign debtor the right to seek a 90-day stay on creditor enforcement and initiate an orderly debt restructuring mechanism.[16] Involvement of G20 members in weighing the evidence for the need for restructuring would encourage credible behavior on the part of the sovereign debtor and would be justified in view of the risks involved for all G20 members as potential creditors (industrialized countries) and future access for middle-income countries to private capital markets, which may be affected by contagion effects.

After public announcement of the decision in favor of a stay for a sovereign debtor, the initial 90-day period would allow the private sector to organize in creditor committees for the forthcoming debt restructuring negotiations and allow international financial institutions like the IMF to find ways to provide the necessary financing.

Costs

As those who activate a restructuring process, debtor countries would be required to bear the costs.

4.4 Civil society engagement

The long-term social and economic hardships that citizens of a financially distressed country are forced to bear even after a successful restructuring process may be seen as a good reason why the parameters for a sustainable debt solution should not be determined solely by a sovereign government and its creditors. It should be ensured that the negotiations would adequately address the need to maintain basic services and no lose sight of the goal of poverty reduction and that social safeguards would be a mandatory feature of the overall package solution. In order to ensure that the sovereign is accountable to its own citizens, it would be important that public parliamentary hearings be held at which the government would report to legislators on the ongoing negotiations and civil society organizations could make their case for a fair and sustainable solution.

4.5 Litigation and other legal issues

The proposal for the IDF does not offer a definitive solution to prevent litigation. To inhibit litigation risks, it would be necessary to establish a legally binding framework for an

16 The initial stay does not protect the sovereign debtor from litigation by its private creditors. It is widely accepted that there is a limited risk for a run to the courthouse, due to an unsatisfactory amount of assets that can be seized by foreign courts; see Bucheit / Gulati (2000, 1).

international insolvency procedure, but even such a procedure would not fully eliminate litigation risks. It must be noted, however, that litigation against a sovereign is difficult, takes a long time, and become more likely if the sovereign takes a long period of time to start a negotiation process with its creditors.

One way to prevent litigation is to include the rules of the IDF in contracts between debtors and creditors. While CACs are only incorporated in bonds, the rules of the IDF could also be extended to other types of contracts such as bank credits and investment treaties.

One recent example of successful litigation was the case of Elliott Associates against the Republic of Peru. In 1995 Peru offered a Brady restructuring that was accompanied by an IMF program. Most private creditors accepted the restructuring. However, some creditors preferred to wait for better restructuring terms. Elliott Associates bought commercial loans that had been secured by the Peruvian Government and were worth US $ 20.7 bn. in the secondary market, and it then rejected participation in the restructuring procedure offered by the Peruvian government. In the interest of avoiding costly and protracted legal action, the Peruvian authorities agreed to pay these creditors more than other creditors (IMF 2001). Exit consents are one instrument used to prevent creditor free-rider behavior; these clauses were used successfully to stop dissenting creditors from undermining the debt workout in the recent debt restructuring process in Ecuador (Nolan 2001).

Exit consents

The objective of exit consents is to prevent free-rider behaviors on the part of creditors in a restructuring of sovereign bonds involving conversion of an old bond issue into new collective action clauses. They for example allow the majority to ignore a minority of bondholders in a restructuring procedure. However, bonds issued under, for example, US law do not include collective action clauses. For this reason modifications of payment terms require the consent of all bondholders.

Exit consents / exit amendments allow a simple majority and the issuer to agree on an amendment of the terms of a bond contract, without modifying payment terms. The contract for an old bond issue is amended in such a way as to make the old issue less attractive than a new one. Bondholders who do not participate in a restructuring process are penalized by the use of exit consents. Such amendments may, for instance, incorporate:

- Adoption of redemption-free periods: the simple majority of bondholders and the sovereign agree upon redemption free periods.

- Reduction of bond liquidity: Old bonds are no longer listed on stock exchanges or quoted by dealers and are thus less liquid and more expensive to sell.

- Abandonment or dilution of financial contract clauses: It is possible to abandon financial clauses, e.g. cross-default clauses. These clauses enable bondholders to require immediate payment from a debtor who defaults on another bond issue.

- Cancellation of clauses that generally permit bondholders to participate in a debt restructuring process.

- Waiver of sovereign immunity: A sovereign issuer may waive his immunity in a bond contract. This waiver of immunity can be cancelled on the basis of exit consents.

These exit consents or amendments serve to make original bond issues less attractive for creditors than the new bonds offered in connection with a restructuring process. This sets an incentive for creditors to participate in the restructuring (Buchheit / Gulati 2000; IMF 2001).

One prominent example for the use of exit consents was the debt restructuring process between the Ecuadorian government and its creditors in 2000. Since no collective action clauses had been included in the bond issues, the Ecuadorian government decided, for the first time, to use exit consents in restructuring its sovereign bond issues. The aim of the authorities was to weaken the contractual rights of bondholders unwilling to participate in the restructuring process. The amendments used in the contract included, for example, cancellation of cross-default clauses and reduction of bond liquidity; as a consequence the old bonds were no longer listed on the Luxembourg stock exchange and thus could no longer be traded there (Buchheit 2000, 23–24; IMF 2001, 8, 11).

As the Ecuadorian case has shown, exit contents can serve as protection against litigation. However, bondholders learn from each debt restructuring process, such as the one in Ecuador in 2000, and will try to protect themselves from the use of exit contents.

5 Conclusion

The absence of a robust framework for sovereign debt restructuring generates important costs and may create systemic instability in the international financial system. The problem is not only that current ad hoc restructuring processes are disorderly and delayed, as we saw in the case of Argentina; the lack of a comprehensive mechanism that deals with all forms of sovereign debt furthermore gives rise to collective action problems that undermine the predictability of restructuring agreements. All this goes to explain why it is important to find new approaches to crisis prevention and crisis resolution when a sovereign debtor is faced with an unsustainable debt burden.

The present paper has laid out a possible approach for a new International Debt Framework (IDF) that seeks the middle ground between a legally binding insolvency procedure such as an SDRM and a voluntary code of conduct. First of all, it does justice to the asymmetries in the governance structures of the international financial system by proposing the establishment of the IDF which would be more representative than the present ad hoc machinery and its related institutions. As part of this approach, a first step would be the creation of a permanent IDF secretariat to promote permanent debtor-creditor dialogue and provide transparency and information on emerging market debt markets. This institutional innovation could not only bolster the important element of crisis prevention, it could also built up trust and understanding between different groups of creditors, which would be vital for potential debt restructuring negotiations, whenever they are required.

Compared to the IMF's SDRM proposal, the IDF approach allows for more flexibility in times of a sovereign debt crisis as it is not statutory in nature. Initiation by a sovereign of the debt restructuring mechanism would entail a temporary stay and bring the ad hoc body of the IDF Commission into play. The IDF Commission would include all private and public creditors in the negotiations, make mediation services available, and define the level of debt relief required for long-term debt sustainability.

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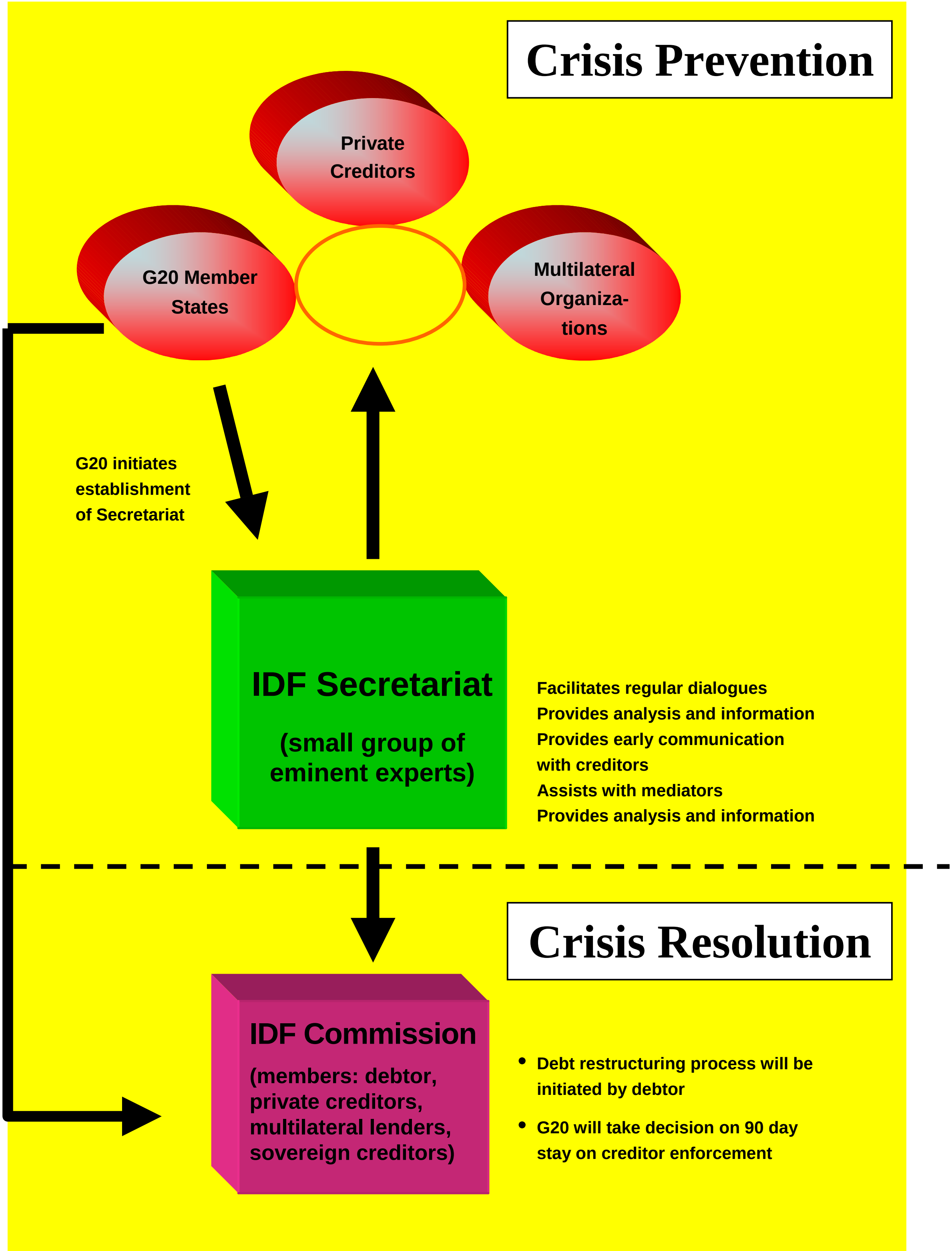
Appendix

The structure of an International Debt Framework (IDF)



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